RICHARD RUSSELL'S DOW THEORY LETTERS INCORPORATED

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June 27, 2001 **LETTER 1320**

June 8, DJIA 10977.01; PTI 5312; A-D Ratio –2.31
June 15, DJIA 10623.64; PTI 5265; A-D Ratio –2.90
June 22, DJIA 10605.26; PTI 5306; A-D Ratio –2.96
***Dow Times Book Value: +6.47**
***Gold 34-day MA: 274 Dow yield: 1.69; Dow p/e: 22.60**

A KEY CHART: Here we see a monthly chart of the S&P 500. The S&P 500 is the index that every mutual fund and hedge fund compare itself with. If your portfolio is down 30%, that's ok as long as the S&P is down 40%. If your portfolio is up 25%, that's fantastic, particularly if the S&P is only up 21%.

The monthly chart of this page shows the S&P turning up in the 1990s, accelerating all through 1999 – but then forming a massive top, and rolling over and heading due south.

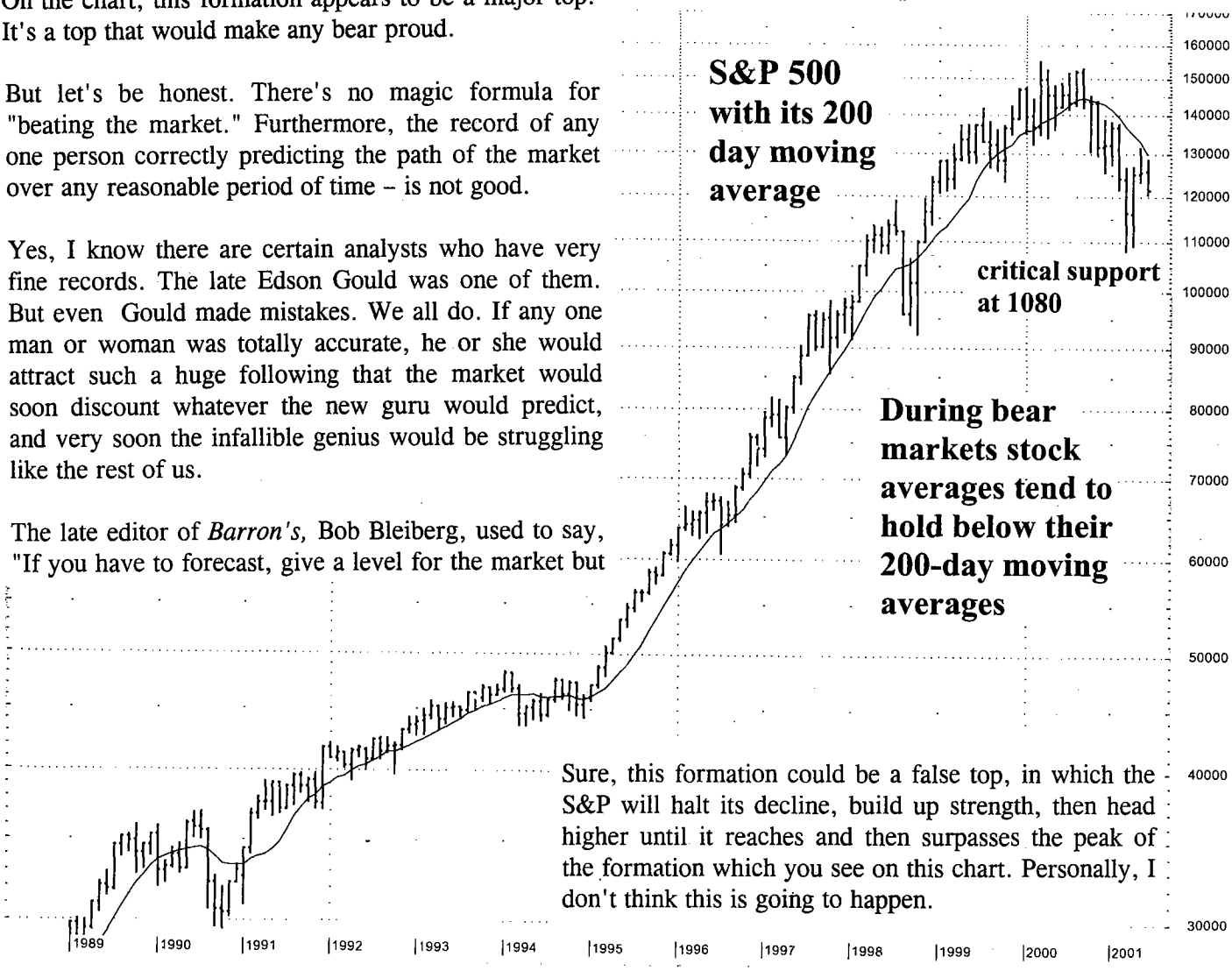
On the chart, this formation appears to be a major top. It's a top that would make any bear proud.

But let's be honest. There's no magic formula for "beating the market." Furthermore, the record of any one person correctly predicting the path of the market over any reasonable period of time – is not good.

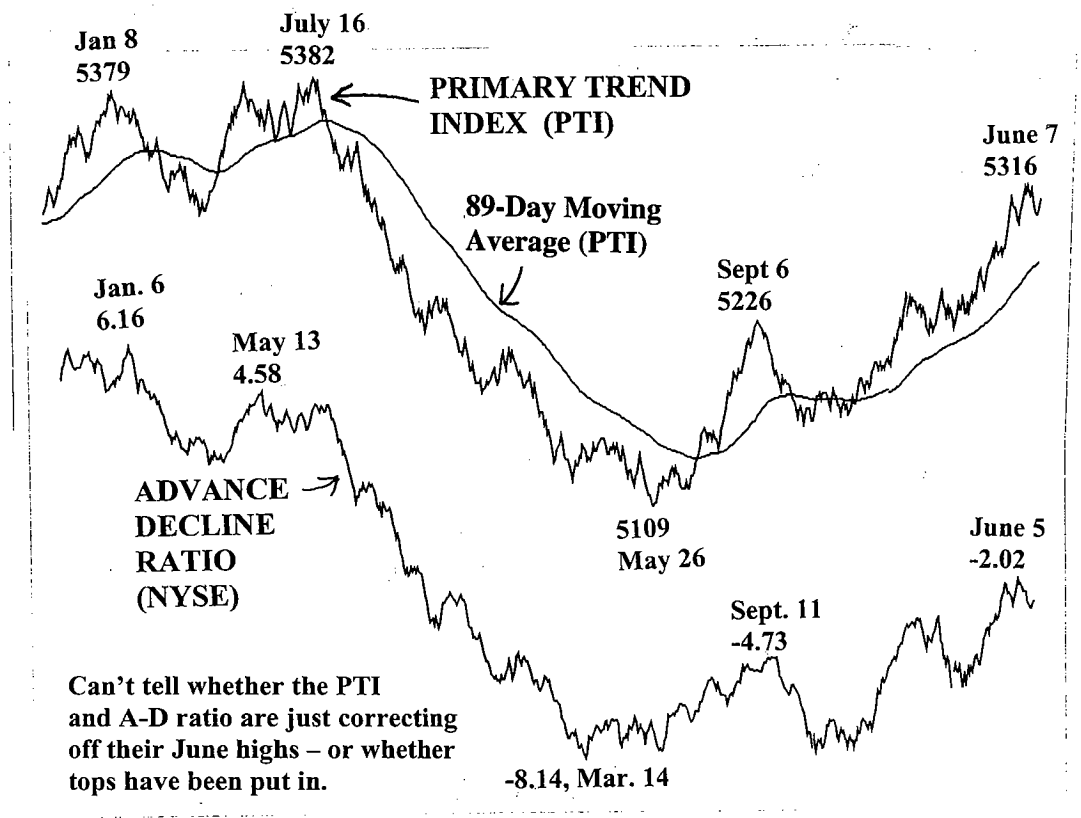
Yes, I know there are certain analysts who have very fine records. The late Edson Gould was one of them. But even Gould made mistakes. We all do. If any one man or woman was totally accurate, he or she would attract such a huge following that the market would soon discount whatever the new guru would predict, and very soon the infallible genius would be struggling like the rest of us.

The late editor of *Barron's,* Bob Bleiberg, used to say, "If you have to forecast, give a level for the market but not a time. Or give a time but not a level. Never give both, because you're absolutely sure to be embarrassed and wrong." Bob knew what he was talking about.

Therefore, I'm just going to say that the monthly chart that you see on page one of this Letter is an extremely valuable picture. It looks like a top, it feels like a top, it acts like a top. I think it is a top. I think it's a huge,very important top.



Sure, this formation could be a false top, in which the S&P will halt its decline, build up strength, then head higher until it reaches and then surpasses the peak of the formation which you see on this chart. Personally, I don't think this is going to happen.



The other resolution would be for the S&P to work its way down. There would be deceptive, even explosive rallies, but each rally peak would halt below the previous rally peak, and each decline would break below the low of the preceding decline. In this way, the S&P would embark on a long, tortuous journey to an eventual bear market bottom. At the bear market bottom, stocks would be at levels that we could term "great values."

CURRENT PICTURE: - After years of inflating the money supply, the Fed has created a totally artificial situation.

Have you ever tried to blow up a balloon? Alan Greenspan has. In fact he's been doing it for years. But note that even when you blow up a balloon you can't just keep exhaling - you've got to pause -- and inhale so you can take another breath. But the Fed never learned that lesson. They just continue to blow up the economic balloon, and instead of pausing, inhaling, allowing the economy to correct, every time the economy stalled a bit, why they exhaled even harder.

Meanwhile, the balloon has sprung a leak. Unemployment is surging, tech activity is in freefall, average hourly earnings for US workers are declining, earnings estimates for US corporations are sinking, US domestic auto sales are falling, commodity prices have backed up. And to make matters worse, the world-leading indicator is dropping while a global recession threatens.

In the face of all the above, the Greenspan Fed has knocked down short rates at the fastest rate since the Greenman took office. At the same time, Greenspan's been flooding the banks with liquidity. All that frantic Fed activity seems to be masking deflationary forces. Gold has grown extremely volatile as it wavers between the forces of Fed-created inflation and deflation in the form of the collapsing economic balloon.

In the meantime, the primary trend of the market and the economy has turned down. This is a force that Greenspan and the Fed has never had to deal with. I'm not even sure that the Fed understands this. After all, haven't they been successful time after time in flooding the banks with liquidity in the face of every crisis from the Russian mess to the Long Term Capital disaster to the Y2K crisis to the Orange County crisis to the Asian crisis?

The stock market has not been asleep. Far from it. It has chosen to react to the well-known rule, "Don't fight the Fed." Pushing off its March-April "bottom," the stock market has been rising in reaction to the Fed's panicky policy.

But lately, the market has been showing cracks. The first crack has been the failure of the Transports to confirm the superior action of the Dow. The second crack has been the sudden dive of the Utility Average. A third more subtle crack has been the collapse of the daily new highs and the increase in daily new lows. A fourth possible crack has been the contraction of volume to below its average for the year so far (average volume has been running at 1.2 billion shares on the NYSE).

Of course, all of the above can be reversed by the market if it wishes. But so far, this has not happened. And we have to deal with what the market is actually doing now -- not what it might be doing sometime in the future.

LONG CYCLES: A most interesting study was sent to me by David Armstrong Pool of Briarcliff, New York.

Those who believe that all you have to do to make money in the market is "hold stocks for the long haul" might study the following statistics carefully.

The Dow from 1914 to 1929 rose 620% over 15 years.

The Dow from 1929 to 1949 was down 58% over 20 years.

The Dow from 1949 to 1966 was up 520% over 17 years.

The Dow from 1966 to 1982 was down 22% over 16 years.

The Dow from 1982 to 2000 was up 1400% over 16 years.

Mr. Poole then estimates that the Dow will be down 30% from 2000 to 2016, a period of 16 years.

Note that the shortest of these cycles was 15 years, the longest was 20 years. The average was 16.8 years.

Can Poole's estimate for the future come to pass? Obviously nobody can foretell the future, but there's a lot of logic in Poole's estimate.

Consider the following: Investors are now paying about 25 dollars for every dollar of S&P earnings. At bear market bottoms they tend to pay about 10 dollars for every dollar of S&P earnings.

Current stock market valuation as a percentage of GDP is around 150%. This is three to five times what we usually see at a bear market bottom.

Currently the S&P is selling at about 85 times dividends. At bear market bottoms the S&P may sell for as little as 15 times dividends.

On this basis, the S&P could have a long way to go on the downside before it hits bear market bottom valuations. This could take time – maybe as long as the 16 years that Mr. Poole estimates. Or we could easily have a series of mini-bull and mini-bear markets within the estimated 16-year bear market.

It is well to remember that valuations at the peak of the 1982 to 2000 bull market were by far the highest in stock market history. In fact, valuations are still sky-high. To work off these high valuations, to work off the extraordinary bullishness which has now enveloped stockholders, could take as long as 16 years. After all, look how long it took to erase the bullishness of 1966 and send sentiment to the despondency of 1982.

At any rate, I thought this study was fascinating and most logical. It could happen. In fact, I'd say that probabilities suggest that it will happen in some form, although not as clean and precise as the statistics above indicate.

If this is our future, what would be the best way to invest? I don't know if there is any "best way." The worst way, I believe, would be to buy and hold overpriced, dividend-less stocks. This is in direct opposition to the current "buy 'em and hold 'em for the long term" philosophy which we hear over and over again.

A better way might be to hold top-grade bonds, assuming that you re-invest all the interest. If stocks are fated to be down 30% over the next 16 years as Poole predicts, then in bonds you'll at least get your principal back with interest compounded over the coming 16 years.

A third way to invest is to try to catch the main advances in stocks while avoiding the main declines. This, of course, entails timing, and timing is something the average investor has never been good at.

This may be where my PTI comes in. One method is simply to buy the DIA and SPY stocks (on the AMEX) when the PTI is bullish and move into money market funds when the PTI is bearish.

INVESTMENT POSITION: The bear remains in the box. With valuations in the market still sky-high or in "never-never land," an increasing number of subscribers are asking me about the strategy and logic of compounding.

This is the way I see it and play it. First, to compound you must be able to save. Ideally, compounding should start when you are young, but it's never too late to start. At any rate, a vital ingredient in compounding is TIME. You can't buy time, but you can certainly teach your kids (who have time on their side) about compounding

In compounding you need an understanding of the mathematics of compounding, and for this the compounding tables are a necessity. One very useful formula is the "72 formula." Divide the number 72 by an interest rate or a dividend yield, and the result will tell how long it takes for money to double. Example. Take a yield of 5%. Divide 72 by 5 and you get 14.4. So it takes 14.4 years for money to double at a rate of 5%.

Let's say you have saved and accumulated $500,000 in assets. You put those assets in a good portfolio of tax-free muni bonds. At 5%, you're receiving $25,000 of tax-free money a year. The idea is to leave as much of that $25,000 alone as possible. Instead of spending it, you re-invest your $25,000 in additional tax-free munis.

In four years you have roughly $600,500 and assuming you can still get 5%, your income becomes $30,000. Repeat this process as long as the bear market goes on.

In the meantime, a bear market in stocks is moving towards its end. If or when the stock market hits a bear market bottom, you can start switching your bonds and bond income into bargain-priced stocks.

What about inflation? Inflation is always a problem, and the best way to beat inflation is to buy stocks at or near the bottom of a bear market at a time when stocks represent great values. We're not there now, and for that reason I believe we have to pick a reasonable alternative. The best alternative or defense is a policy of compounding, particularly tax-free compounding – or compounding in a tax-deferred fund.

NOTES & QUOTES: As older readers know, I've been a huge booster for dividends vs. non-dividend paying stocks. One of the main reasons I insist on dividends is that with dividends I can not only diversify, I can compound.

There's nothing more discouraging in investing, to my mind, than buying a stock in a great organization like Berkshire Hathaway, say buying the stock at $80,000, watching it sink to $44,000, then rally to $65,000 and in all that time never collecting a nickel in dividends.

Here's an amazing statistic which demonstrates the value of dividends. If you had invested $100 in the S&P 500 in 1926 and just sat with the S&P without investing the dividends you would have **$9,844** today.

But if you had reinvested all the dividends you would have **$247,352** today. Quite a difference, wouldn't you say?

* *

Analysts today are beginning to add up the cost of the giant telecom disaster. With 110,000 layoffs over the past two years, telecom has let more people go than any other industry.

What happened? The Telecom Act of 1996 set off a stampede of competition by opening the lucrative local-telephone markets to new outfits. At the same time the Internet was exploding, and technology mavens were saying that high-speed networks would be needed to serve our needs and desires.

The gold rush started. Nearly 400 telecom companies raised $490 billion in the stock market while they took on an additional $400 billion in debt. Wall Street was hysterical with excitement and lined up eager backers for the telecom industry. Next came the Nasdaq crash. Financiers suddenly realized that all these hundreds of telecom companies couldn't possibly succeed.

Almost overnight, the money spigot was turned off. Companies that had completed a part or even half of their needed total were stranded. It is estimated that each telecom company is connected or involved with four other companies. As one after the other telecom company was squeezed or failed, the misery spread. Fiber optic companies were next to be killed. It was a domino effect.

Nobody knows how much money will ultimately be lost. It's certain that over $650 billion will go down the drain, and before it's all over probably over one trillion will be lost.

Ironically, of all the millions of miles of wire that has been paid by the telecom companies, just over 2% will actually be "hot" or actually in use. The disaster in the telecom industry has already passed the worst of the S&L mess. It will be years before it is all settled.

* *

I was just looking over statistics for Morgan Stanley Dean Witter. What struck me is this: Morgan's retail brokerage business is responsible for only 10% of its revenue. I imagine that Merrill is not too different. This is why neither of these two giant outfits has competed for the retail stock business via low commissions. The retail business for them is just a way of distributing deals. Morgan and Merrill are in the investment banking and money business, not the retail commission business. Times have changed and so have these two outfits.

* *

Steve Milunovich of Merrill Lynch states, "On average, real tech earnings are less than they appear. As a result, valuations are higher than investors think. Probably the biggest single contributor to tech stocks' earnings during the recent mania was their use of stock options which companies bestowed on employees in lieu of higher salaries.

Cost of options is not considered a wage expense. Also, companies receive large tax deductions from stock options when they are exercised. For example, stock option tax benefits made up 67% of operating cash flow at Sun Microsystems, 41% at Cisco, 34% at Yahoo and 30% at Juniper Networks.

* *

If you live in the San Diego area, you no longer have to go to New York City to find great food. Faye and I just had the "tasting dinner" at La Jolla's George's at the Cove restaurant. This was a truly great dinner, at what I consider a bargain price compared with what we had recently in New York. The tasting dinner at George's runs $52 (five courses) vs. $115 at Jean-George (seven courses) in NYC (Jean-George is arguably NYC's top restaurant). I felt that the dinner at George's at the Cove was as good as the dinner at Jean-George, but with two less courses. And the dinner at George's was actually better than the tasting dinner at New York's famous Le Bernadin.

Two weeks ago we ate at the famous Chez Panisse restaurant in Berkeley. I was very disappointed. This restaurant is extremely over-rated in my opinion. It's trading on its name.

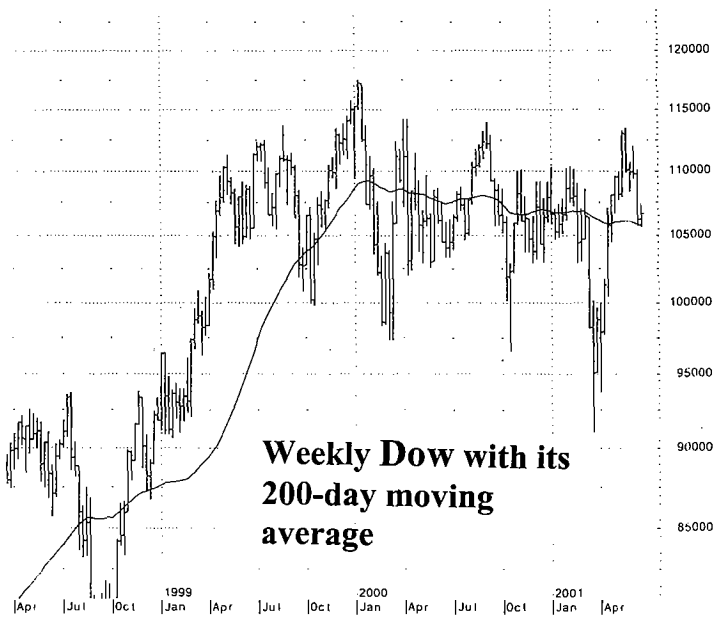
* *

One of the biggest problems for the current US economy is the sky-high level of consumer debt. Latest statistics show that consumers are paying out over 14% of disposable income in debt service. This is unsustainable, and it will have to lead to less buying and more paying-off of debt. As the economy slowed, many consumers (particularly those who were laid off) were living off their credit cards. Consumer purchases on credit are still extremely high. Nothing, it seems, will halt the US consumers' wild flight to debt and spending – nothing so far.

DOW: In contrast with the chart of the S&P shown on page 1, this is a weekly chart of the Dow along with its 200-day moving average.

You may not realize it, but the Dow has been in a wide-swinging trading range ever since April of 1999. This is rather usual in areas of very high volatility. Areas of high volatility often end up about where they started with the item in question having gone nowhere.

Note that the 200-day moving average of the Dow turned down around the end of January 2000. Since then it has been trailing down on a very low slope.



Weekly Dow with its 200-day moving average

As this is written, the Dow is just a few points above its 200-day MA. Note the we now have a rather subtle series of declining tops and declining bottoms in the Dow. This is the recipe for a declining market, but so far the swings have been extremely subtle, and the direction of the Dow is not clear.

For a clear upside breakout, the Dow would have to rally above its May 21 closing price of **11337.92.** Since the Transports are now so far from confirming, this kind of Dow breakout would actually appear dangerous – unless the Transports were in a mood to confirm.

Ironically, back in May of 1999 the Dow hit a high of 11130. The Dow is below that level now. Two years of wide swings with essentially no progress. What does it mean?

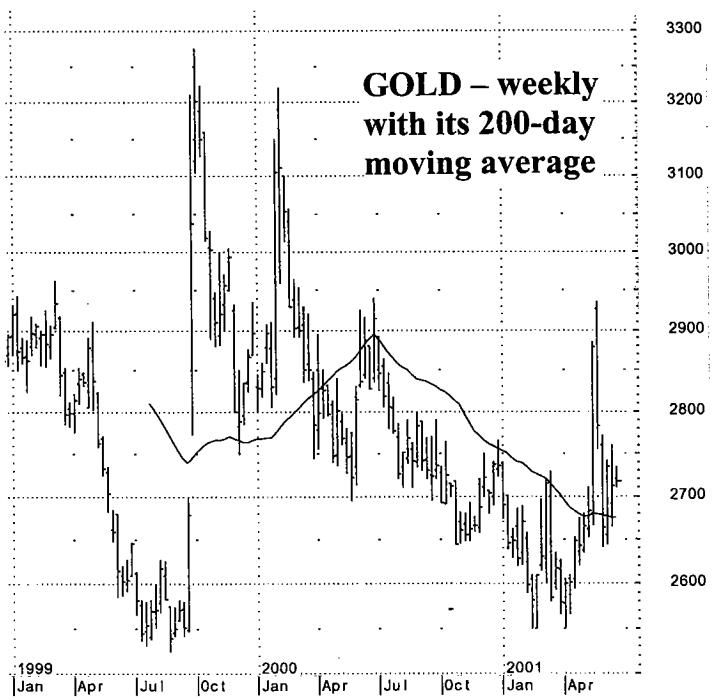
I think it means that stocks have been extremely overvalued and that the overvaluation has stopped the blue-chips dead in their tracks.

As for the upside action in the stock market, it really all occurred during tech madness where valuations were completely ignored. But the lesson – look where the techs are now.

GOLD: The inflation argument goes on and on and on. Greenspan says that he sees no acceleration in inflation. But I receive e-mail after e-mail complaining about the cost-of-living. The average person feels inflation. Can they all be wrong?

This is a weekly chart of gold along with its 200-day moving average. Gold has been holding above its 200-day MA for over six weeks. The 200-day MA now stands at 267.

The problem with this chart picture of gold is the overhanging supply, as seen in the mid-May surge of gold to the 290 level. Was this a fake-out, a technical mini blow-off in gold, or was this a preview of what lies ahead? There's no way of knowing at this time.



The fact that gold has been holding steadily above its 200-day MA is a technical plus for gold. But the fact that following the mid-May surge, gold fell back so precipitously, is a definite negative. For the moment, gold is in a hopeful but unproved state. We'll just have to see more.

NEXT MAILING: July 18, 2001

BONDS: One advantage of charts is that they cut through all the talk. This is a daily chart of the bellwether 10 year T-note (Sept. futures). What we see here is a good bottoming pattern with an upside breakout on June 22.

What's interesting is that the notes are this strong in the face of an almost consensus opinion that rates will be heading up as inflation picks up.

One reason why notes and bonds are turning strong is that they provide income, whereas stocks are now providing little or no income at all.

LATE NOTES: The decline so far has been a product of a lack of buying rather than any real selling pressure. It's a stalemate on both sides -- buyers hesitating to buy and sellers holding off because they believe the economy is close to turning up. Meanwhile, volatility is simmering down. Holders of tech stocks are still playing "the crying game." But most traders and investors are now playing "the waiting game."